K&L GATES

US ASSET MANAGEMENT REGULATORY YEAR IN REVIEW 2023

A MESSAGE FROM OUR AUTHORS

It is a dramatic understatement to describe 2023 as a busy year in the United States for asset management regulation.

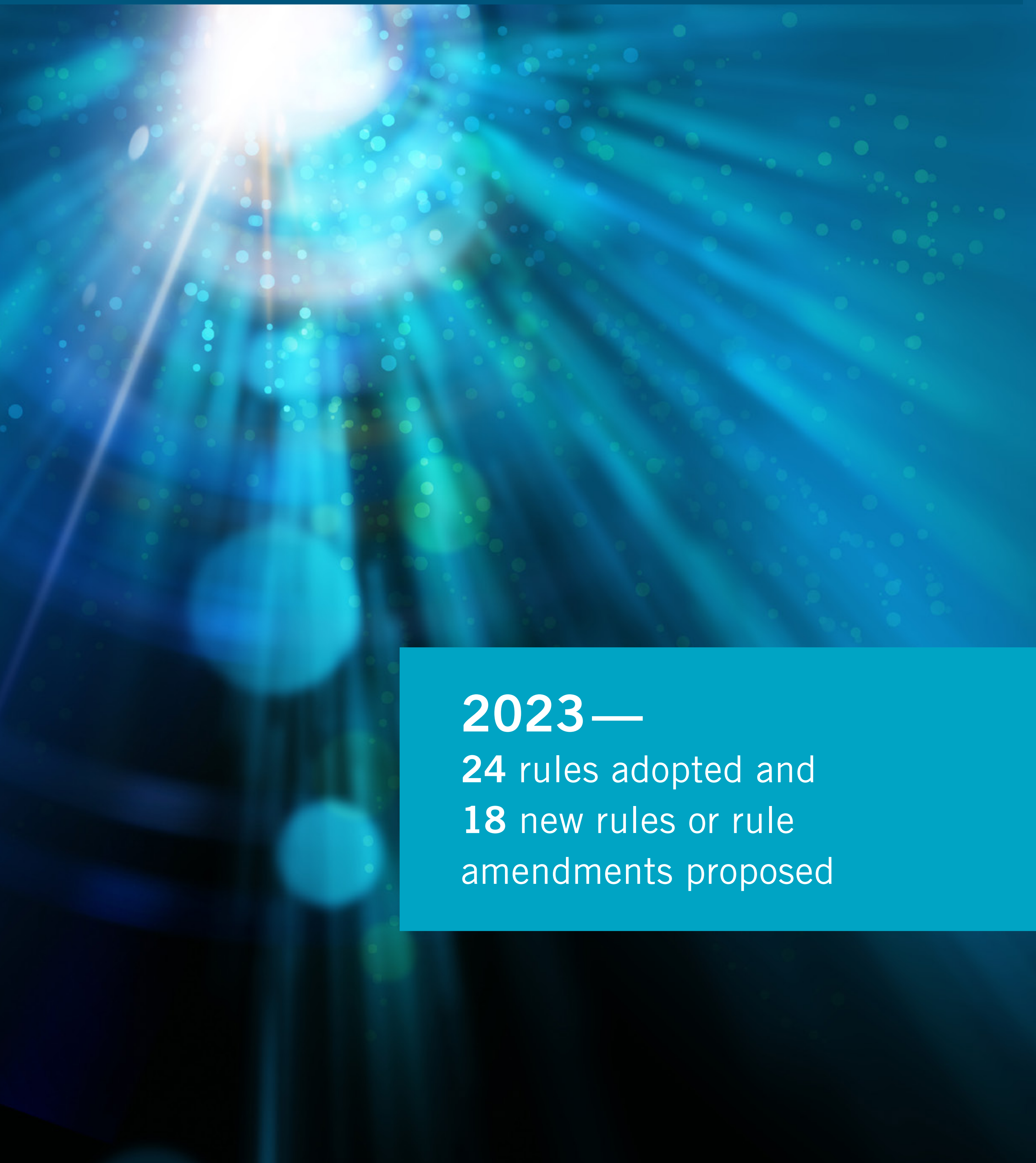
With 24 rules adopted and 18 new rules or rule amendments proposed, the US Securities and Exchange Commission (SEC) continued a rapid pace implementing its unprecedented regulatory agenda. One prevailing theme of this regulatory activity is operational resiliency, with many of the regulatory actions addressing market structure issues (e.g., transition to one business day after the trade date (T+1)) or imposing prescriptive requirements on asset manager operations (e.g., predictive data analytics). The year also continued the trend of SEC regulations requiring more frequent data production to the SEC for market surveillance purposes, such as the new requirements under Form PF (applicable to private funds) for filings to be made within days of an occurrence of certain events. The SEC was not the only regulator at work; the US Department of Labor entered the mix with proposed amendments to the definition of fiduciary under the Employee Retirement Income Security Act of 1974, as amended (ERISA).

In addition to regulatory activity, there were many notable developments with respect to asset manager examinations and enforcement with the SEC continuing to focus on bringing cases and examinations underscoring key priorities, such as off-channel communications and compliance with the new Rule 206(4)-1 (Marketing Rule) under the Investment Advisers Act of 1940 (Advisers Act). Developments have also come through litigation, with a pair of court decisions potentially impacting the ability for closed-end funds to adopt and enforce protective "control share" provisions.

No year in review can be complete without discussing the developments around environmental, social, and governance (ESG) investing. Fracturing of the US regulatory landscape continued in 2023 with several states considering and adopting laws and regulations governing how ESG investing may be pursued by asset managers engaged by state pension plans, or, in two instances, specifically regulating asset manager conduct. In addition, state executive agencies have been active with a multistate ESG investigation of asset managers.

Critically, we can project what 2024 will bring by looking at what has been included on the aggressive SEC agenda but remains to be done: climate risk disclosure for public companies; ESG disclosure rules for mutual funds and investment advisers; revisions to the investment adviser custody rule; revisions to the mutual fund liquidity rule and the potential imposition of swing pricing (and a hard close); and the list goes on.

We highlight in this piece some of the key developments from 2023 that we have been working on with our clients. The pace of regulatory change is quick and its scope is vast. The summaries below represent a brief overview and only a portion of the regulatory activity from the SEC and other regulators that could have an impact on the asset management industry going forward.



2023—

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US ASSET MANAGEMENT REGULATORY YEAR IN REVIEW 2023

I. REGULATORY ACTIVITY

A. Proposed Rules

1. Liquidity Risk Management and Swing Pricing Proposal

Although actually proposed in November 2022, the **SEC's proposed rules regarding Liquidity Risk Management and Swing Pricing** (the Liquidity Proposals) garnered headlines with significant industry—and political—opposition throughout 2023. In sum, the Liquidity Proposals would amend existing rules requiring US mutual funds to establish liquidity risk management programs and would require US mutual funds to implement swing pricing, a method of calculating a fund's net asset value that would account for transaction costs associated with shareholder activity.

The opposition focused on two key features of the Liquidity Proposals: (i) the elimination of the "less liquid security" classification established in Rule 22e-4 under the Investment Company Act of 1940 (1940 Act); and (ii) the imposition of a swing pricing and associated "hard close" requirement. Industry commenters and trade organizations raised concerns throughout 2023 that the elimination of the "less liquid security" classification would effectively prohibit US mutual funds from adopting a strategy of investing in bank loans, an asset class associated with long settlement periods.

Trade organizations, industry participants, and even a bipartisan group of lawmakers also lodged objections to the swing pricing element of the Liquidity Proposals. To appropriately implement swing pricing, the SEC proposed that US mutual funds would be required to implement a hard close, which would mean that only purchase or redemption orders received by the fund itself (as opposed to an intermediary such as a broker-dealer) would receive that day's price. The opposition to the "hard close" requirement was strong throughout 2023, with commenters noting significant operational challenges that would be harmful to fund investors. Although SEC chairman Gary Gensler defended the concept of hard close, it may be telling that (as discussed in more detail below) the SEC previously adopted amendments to money market fund regulations that did not include a swing pricing requirement, even though such a requirement was included in the original proposal.

The Liquidity Proposals remain on the SEC's regulatory agenda with an expected finalization date of April 2024, according to the SEC's most recently published regulatory flexibility agenda.

2. Safekeeping

On 15 February 2023, the SEC **proposed to overhaul the custody framework for SEC-registered investment advisers.** The proposed amendments would amend and redesignate Rule 206(4)-2 (the Custody Rule) under the Advisers Act as Rule 223-1 (the Safeguarding Rule). The proposed Safeguarding Rule would expand the requirements of the Custody Rule. Among other things, the Safeguarding Rule: (i) broadens the scope of assets covered; (ii) includes discretionary authority to trade as conferring custody; (iii) expands (and complicates) the qualified custodian's role; (iv) requires investment advisers to enter into written agreements with custodians; (v) requires investment advisers to obtain written reasonable assurances from custodians; (vi) limits the utility of the exception for privately offered securities (but expands it to physical assets); (vii) expands the availability of the audit provision beyond pooled vehicles; (viii) creates exceptions from the surprise examination requirement for custody solely because of discretionary authority or a standing letter of authorization; and (ix) updates rules regarding recordkeeping and Form ADV.

The proposed Safeguarding Rule received significant pushback from commenters, noting that the increase in scope of the rule was unnecessary, and the new requirements with respect to client contracts with their custodian represented a regulatory overreach. In response to these comments, in an unusual move, the SEC **reopened the comment period** for an additional 60 days, closing on 29 October 2023.

3. Predictive Data

The SEC proposed a set of **Predictive Analytics Rules** that would, if adopted, require broker-dealers and investment advisers to: (i) identify conflicts of interest when using certain technology in interactions with investors; and (ii) adopt policies and procedures that eliminate or neutralize (rather than disclose or mitigate) those conflicts of interest. The Predictive Analytics Rules would cover a broad range of technology that includes not just artificial intelligence (AI), but also any other analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors (Covered Technology). The proposal would apply in situations where firms use Covered Technology in connection with the firm's engagement or communication with an investor, including by exercising discretion with respect to an investor's account, providing information to an investor, or soliciting an investor. This includes communication that takes place in person, on a website, via smartphones, through computer applications, or by email, among other modes of communication. Because of the manner in which the term investor is defined, the Predictive Analytics Rules apply differently to broker-dealers and investment advisers. Specifically, the Predictive Analytics Rules would apply with respect to Covered Technology used in interactions with all clients of an investment adviser, including institutional investors, as well as investors in registered funds and certain private funds. For broker-dealers, the Predictive Analytics Rules, however, would only apply with respect to interactions with retail customers.

The broad and disruptive impact that these changes could have is highly controversial and multiple industry groups have called on the SEC to withdraw the rule proposal.

4. DOL Fiduciary Rule

The DOL, on 31 October 2023, proposed the **Retirement Security Rule** to redefine who is an investment advice fiduciary under ERISA. The DOL also proposed amendments to several existing prohibited transaction exemptions (PTEs) that provide prohibited transaction relief to investment advice fiduciaries. The Retirement Security Rule would replace the current five-part test governing who is a "fiduciary" under ERISA. Under the proposed amendments, a person making an investment recommendation would be a fiduciary if:

(i) the person has discretionary authority or control with respect to purchasing or selling securities or other investment property for the retirement investor; (ii) the person makes investment recommendations to investors on a regular basis as part of their business, and it is indicated that the recommendation is based on the particular needs or circumstances of the retirement investor and may be relied upon by such investor; or (iii) the person making the recommendation represents or acknowledges that they are acting as a fiduciary when making investment recommendations.

The proposed amendments to PTEs would generally remove their applicability for investment advice and compel investment advice fiduciaries to rely on PTE 2020-02, which generally requires entities to act in the best interests of their customers.

5. FINRA Performance Projection Rule

The Financial Industry Regulatory Authority (FINRA) proposed a **significant rule change** that would better align FINRA's and the SEC's regulatory frameworks related to the use of performance projections in marketing material. FINRA's proposal would, subject to certain conditions, permit: (i) projections of performance or targeted returns broadly in communications with institutional investors; and (ii) projected performance and targeted returns for private funds[1] in communications limited to "qualified purchasers" as defined in the 1940 Act (i.e., investors who may invest in private funds that rely on the exemption in Section 3(c)(7) of the 1940 Act. As proposed, the conditions would be: (i) the FINRA member has adopted policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication; (ii) the FINRA member has a reasonable basis for the criteria and assumptions used to calculate the projections or targets; and (iii) the communication includes certain disclosures and information.

This proposal represents an important step in aligning FINRA advertising regulations with the SEC's new Marketing Rule applicable to registered investment advisers and a softening of FINRA's historically firm stance in prohibiting performance projections.

B. Adopted Rules

1. Shortening the Settlement Period to T+1

On the market structure side, the SEC **adopted amended rules** that will effectively reduce the settlement period for securities traded through US broker-dealers from two business days after the trade date (T+2) to T+1. In addition, the SEC adopted a new rule (Rule 15c6-2) that would require broker-dealers to promote same day "affirmation, allocation and confirmation" (confirmation) in trades with institutional investors through either: (i) required provisions in the customer contract; or (ii) adopting certain policies and procedures reasonably designed to encourage same-day confirmation. As part of this package, the SEC adopted amendments to the recordkeeping provisions under the Advisers Act requiring investment advisers to create and retain new records relating to the confirmation process.

These rules go into effect 28 May 2024. The industry collectively has been working diligently to update processes and implement tools to ensure the transition will be successful. That said, several open questions remain concerning the impact of this change on investment advisers. For example, investment advisers will need to determine how to deal with settlement mismatches between investments in US securities and securities in foreign jurisdictions that retain the T+2 timeline, which may be especially complex for exchange-traded funds that accept foreign securities in-kind but will be required to settle their own shares on a T+1 basis. The change may also have impacts on other activities, such as securities lending.

[1] The permission could include investments other than private funds, as it is limited to offerings in a "private placement that is sold solely to [qualified purchasers]," but the immediate impact would be with respect to the sale of private funds.

The SEC is continuing to focus on bringing cases and examinations underscoring key priorities.

Investment advisers will need to work with their broker-dealer counterparties to ensure the adviser's workflows are consistent with the processes adopted by the broker-dealer for the same-day confirmation process, including ensuring the advisers' operations are compatible with their broker-dealers' new policies and procedures.

2. Money Market Fund Reforms

In 2023, the SEC took additional steps with respect to the resiliency and transparency of money market funds (MMFs) by **adopting amendments to Rule 2a-7 under the 1940 Act** (the MMF Amendments). The MMF Amendments were first proposed by the SEC in a December 2021 release and reflect the SEC's concerns stemming from market stresses experienced by MMFs in connection with the COVID-19 pandemic in March 2020.

The MMF Amendments impose mandatory liquidity fees for institutional prime and institutional tax-exempt money market funds when a fund has daily net redemptions that exceed 5% of net assets. They eliminate redemption gates and the link between weekly liquid assets and liquidity fees, which were part of the 2014 amendments. Additionally, the MMF Amendments: (i) permit nongovernment money market funds to impose discretionary liquidity fees if the fund's board determines that a fee is in the best interest of the fund; (ii) increase the minimum daily and weekly liquidity requirements to provide a larger buffer in the event of rapid redemptions; (iii) permit retail and government money market funds to convert from stable share price to a floating share price or to reduce the number of shares outstanding to maintain a stable net asset value per share; (iv) standardize the calculation of maturity measures and amend certain reporting forms to reflect the other amendments adopted as part of the final rule; and (v) amend Form PF to require additional reporting for private liquidity funds in line with the reporting for registered money market funds.

Critically, the MMF Amendments did not include provisions requiring swing pricing as originally proposed.

The effective date for most of the MMF Amendments was on 2 October 2023, and the SEC adopted the following tiered compliance dates:

- 2 October 2023: provisions removing fees and gates and technical amendments to Form N-1A and N-CSR;
- 2 April 2024: increases to the daily and weekly liquidity requirements and discretionary liquidity fees; and
- 2 October 2024: mandatory liquidity fee requirements.

The effective and compliance dates for the amendments to Forms N-CR, N-MFP, and PF will be 11 June 2024.

Our alert contains more detail on the MMF Amendments as well as a comparison chart highlighting the changes made by the MMF Amendments.

3. Form PF

On 3 May 2023, the SEC **approved amendments to Form PF.** Advisers with at least US$1.5 billion in assets under management (AUM) attributable to hedge funds must report certain events (extraordinary investment losses, significant margin and default events, and large withdrawal and redemption requests) to the SEC as soon as practicable but no later than 72 hours after they occur. Private equity fund advisers must file a quarterly report detailing: (i) completion of an adviser-led secondary; or (ii) an investor election to remove a fund's general partner or to terminate a fund's investment period during the preceding quarter. In addition, on an annual basis, advisers with US$2 billion or more of private equity fund AUM must disclose a range of new information, including: (i) information about the implementation of general partner and certain significant limited partner clawbacks; (ii) details about a fund's investment strategies; (iii) additional information about fund-level borrowings; (iv) more granular information about the nature of reported events of default; (v) additional identifying information about institutions providing bridge financings; and (vi) information about a fund's greatest country exposures. The compliance date for the new current reporting events for large hedge fund advisers and quarterly reporting events for all private equity fund advisers began on 11 December 2023. The annual reporting requirements for large private equity fund advisers will be effective on 11 June 2024.

4. Fund Names

On 20 September 2023, the SEC adopted **amendments to Rule 35d-1** (the Names Rule). The amendments (i) expand the scope of terms under the Names Rule that would require a fund to adopt an 80% policy to include terms in a fund name that suggest the fund focuses on investments that have "particular characteristics;" (ii) require funds that adopt an 80% policy to define in their prospectuses the terms used in their names, including the criteria the funds use to select the investments that the terms describe; and (iii) require funds with 80% policies to conduct reviews at least quarterly of their holdings to assess compliance with their 80% policies. The amendments change how funds value derivatives and short positions and expand recordkeeping and reporting requirements under Form N-PORT. Finally, the amendments introduced new limits for changes to their 80% policies by unlisted closed-end funds and business development companies.

5. Private Fund Adviser Rules

On 23 August 2023, the SEC adopted **rules regarding the management and operation of private funds by investment advisers.** The new rules create a restrictive framework that prohibits certain preferential treatment outright and allows certain restricted activities to be undertaken with appropriate disclosure or investor consent. The new rules include: (i) requirements for the delivery and presentation of quarterly statements; (ii) a requirement that registered investment advisers obtain an annual audit of the financial statements of each of their private funds; and (iii) a requirement that they distribute to investors either a fairness opinion or a valuation opinion in advance of an adviser-led secondary.

The rules will impose a number of new requirements on registered and unregistered advisers to private funds, subject to limited exemptions. The new private fund adviser rules are comprehensive and will have significant impacts on how private funds are managed, offered, and sold. **Our alert** contains more detail on these new rules.

6. Beneficial Ownership Reporting

On 10 October 2023, the SEC adopted **amendments to Regulation 13D-G** under the Securities and Exchange Act of 1934 (Exchange Act). Most significantly, the amendments: (i) shorten the filing deadlines for initial and amended beneficial ownership reports filed on Schedules 13D and 13G; (ii) extend the deadline by which Schedules 13D and 13G must be filed on a given business day to 10 PM ET; (iii) clarify the disclosure requirements of Schedule 13D with respect to derivative securities; (iv) clarify the circumstances in which a "group" may be considered to exist under the beneficial ownership rules; and (v) require that Schedule 13D and 13G filings be made using a structured, machine-readable data language. The amendments will be effective and compliance will be required by: (i) 5 February 2024 for Schedule 13D (except as noted in sub-clause (iii) below); (ii) 30 September 2024 for Schedule 13G; and (iii) 18 December 2024 for the structured data requirement for both Schedules 13D and 13G.

II. LITIGATION, ENFORCEMENT, AND EXAMINATIONS

A. SEC Enforcement Year in Review

In fiscal year 2023, which ended on 30 September 2023, the SEC filed 784 enforcement actions, up 3% from fiscal year 2022. The SEC recovered nearly US$5 billion in penalties and disgorgements, which represented the second highest amount in SEC history, but a near 25% decline from 2022's record-setting results. Enforcement actions focused on a number of themes, including, among others: (i) off-channel communications; (ii) whistleblowers; (iii) crypto; (iv) ESG-related cases; and (v) Foreign Corrupt Practice Act of 1977 (FCPA).

B. Off-channel Communications

The SEC's examination priorities for 2023 included recordkeeping and supervisory programs for business-related electronic communication. This follows well-publicized enforcement actions by both the SEC and the Commodity Futures Trading Commission (CFTC). Broker-dealers are subject to record retention requirements enumerated in Exchange Act Rule 17a-4, and investment advisers are subject to record retention requirements set forth in Advisers Act Rule 204-2. Additionally, Sections 4g and 4s of the Commodity Exchange Act (and related regulations) require that swap dealers and other CFTC registrants retain comprehensive records of their business-related communications. Recently, the SEC has been clear that recordkeeping requirements apply to off-channel communications. In 2021, the SEC and CFTC resolved charges against a firm for "widespread and longstanding failures by the firm and its employees to maintain and preserve" business-related communications occurring over text message, WhatsApp, and personal email accounts. In 2022, charges centered on the failure of 15 high-profile broker-dealers and one investment adviser to implement and maintain proper controls for business-related communications led to US$1.1 billion in penalties. The regulators focused on the following facts: (i) the widespread and pervasive use of unrecorded business-related communication conducted through "off-channel" mediums, including text messages, personal email, WhatsApp, and Signal; (ii) the existence of record retention policies and procedures that were not followed, enforced, or reviewed; and (iii) management and supervisors tasked with enforcing policies and procedures related to record retention and off-channel communications violated such policies and procedures themselves. During 2023, 25 broker-dealers, advisers, and credit rating agencies agreed to pay more than US$400 million for alleged widespread misuse of personal devices and apps, such as WhatsApp, for business transactions, which violated the SEC's recordkeeping requirements. These recent enforcement actions reiterate that regulators are focused on ensuring the preservation of all records that are required to be maintained under applicable law, which capture certain off-channel, business-related communications between colleagues, clients, broker-dealer customers, and other persons connected to securities, commodities, or swaps-related businesses. The SEC is likely to continue to focus on these communications going forward.

C. Whistleblowers

Whistleblowing continues to be an important element of the SEC's efforts with respect to market surveillance. In 2023, the SEC received more than 18,000 whistleblower tips, approximately 50% more than in 2022, and the SEC paid out nearly US$600 million in whistleblower awards, including its largest-ever award to a single whistleblower of US$279 million.

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Given the importance of whistleblowing to the SEC, the SEC has taken action against firms for activities that impermissibly chill potential whistleblowers. For example, the SEC took action against: (i) a registered investment adviser who raised impediments to whistleblowing by requiring employees to sign agreements prohibiting the disclosure of confidential corporate information to third parties; and (ii) several other firms who used employment and separation agreements that violated the whistleblower protection rule.

D. Crypto and Digital Assets

During 2023, the SEC placed the digital asset industry squarely within its enforcement crosshairs. SEC digital asset enforcement targeted a wide range of alleged misconduct, such as a company and its CEO allegedly defrauding investors after raising billions of dollars in alleged unregistered securities transactions; a company operating the largest crypto asset trading platform in the world allegedly operating as an unregistered exchange, clearing agency, and broker-dealer and for the alleged unregistered offer and sale of the company's own crypto assets; and famously, Sam Bankman-Fried, CEO of the crypto trading platform FTX, coordinating a scheme to defraud investors. Further, for the first time, the SEC brought action against issuers of nonfungible tokens who were charged with selling unregistered securities. Right before the end of the year, the SEC announced settled charges against a decentralized autonomous organization and its founders, alleging that the individual digital asset pools operated by the decentralized autonomous organization were "investment companies," and the assets offered by and traded through the pools were securities. The SEC's aggressive position with respect to the decentralized autonomous organization in this instance suggests that a notably broad number of participants in the decentralized finance space will likely be under scrutiny by the SEC during the upcoming year.

E. Foreign Corrupt Practices Act

The SEC stated it will remain committed to enforcing the FCPA against issuers of securities traded in the United States that engage in bribery and other corrupt practices abroad. The SEC brought charges against a global chemical company based in the United States for, among other violations, using agents that paid bribes to obtain contracts in Vietnam, India, and Indonesia. To settle the charges, the company agreed to pay more than US$100 million in disgorgement and prejudgment interest. The SEC also charged an Amsterdam-based medical supplier for allegedly improper conduct by its subsidiaries in China, including conduct to influence hospital officials to draft tenders to favor the company's products. The company paid more than US$62 million in a combined civil penalty, disgorgement, and prejudgment interest to settle the charges.

F. Artificial Intelligence

The SEC staff turned its examination focus to AI by conducting a series of sweep examinations. The content and requests of these examinations evolved over time as the SEC staff gained experience with the subject matter. The SEC staff appears to be examining not only how AI is incorporated into the investment process for purposes of making investment decisions or generating trading signals, but also how the adviser's use of AI comports with any marketing material the adviser uses to promote its use of AI. This line of examination suggests the SEC is interested not only in learning more about the use of AI in the industry, but also assessing whether advisers are engaging in "AI-washing" by overstating their firm's implementation of AI technology.

G. Investment Adviser and Fund Marketing

On 11 September 2023, the SEC announced charges against nine investment advisers for violations of the Marketing Rule based on the presentation of hypothetical performance and failure to retain copies of each advertisement an adviser disseminates in accordance with the recordkeeping requirements. The orders resulted in combined penalties of US$850,000. Each of the respondent advisers included hypothetical performance on their websites on an unrestricted basis, resulting in hypothetical performance being disseminated in advertisements to a mass audience in contravention of the Marketing Rule. Specifically, the SEC noted that the advisers either did not have or did not implement the policies and procedures governing the presentation of hypothetical performance designed to ensure that such hypothetical performance was relevant to the likely financial situation and objectives of the intended audience. In two of the settlements, the SEC brought charges against advisers for being unable to produce a copy of the website presentation of their hypothetical performance either because the webpage was changed prior to being saved or because the adviser failed to ensure the outside service provider had archived the pages.

In addition, the SEC staff continued examining investment advisers with respect to their compliance with the Marketing Rule through sweep examinations. These sweep examinations request comprehensive information relating to advertising practices, including (i) identification of supervised persons involved in the creation, review, dissemination, or retention of advertisements; (ii) training and testing relating to compliance with the Marketing Rule; (iii) sponsored or other events at which the adviser presented or provided marketing materials; (iv) the use of testimonials and endorsements; (v) composite construction and performance calculation information; and (vi) the use of hypothetical performance. The persistence of Marketing Rule sweep examinations indicates that compliance with this rule remains a significant focus for the SEC staff.

H. Control Share Provisions

2023 brought increased litigation relating to control share provisions adopted by closed-end funds (CEFs) that are registered under the 1940 Act and whose shares are listed on a stock exchange. Control share provisions generally prohibit an acquirer of "control shares"—which are shares acquired above certain enumerated ownership thresholds (e.g., 10%, 15%, and 20% of the shares outstanding)—from voting those control shares unless or until the acquirer obtains the approval of a certain percentage of the disinterested stockholders. In this way, control share provisions can be a defensive tool to limit activist investors' ability to pursue arbitrage opportunities arising when a CEF's shares trade at a market price that is lower than the fund's net asset value per share.

CEFs are subject to the provisions of the 1940 Act, including Section 18(i), which states, in pertinent part, that "[e]xcept… as otherwise required by law, every share of stock…shall have equal voting rights with every other outstanding voting stock." Two courts reviewed the legality of control share provisions under this statute, and both concluded that the control share provisions at issue were inconsistent with the requirements of Section 18(i). First, the Second Circuit affirmed a February 2022 decision by the US District Court for the Southern District of New York (SDNY) in favor of an activist hedge fund and its adviser, finding that control share provisions in certain CEF by-laws violated Section 18(i) of the 1940 Act. Later in the year, on 5 December 2023, a different judge in the SDNY granted summary judgment in favor of the same activist in a separate action, also finding, without significant discussion, that the control share provisions at issue—which were adopted pursuant to a Maryland statute authorizing such provisions—were inconsistent with the requirements of Section 18(i).

The defendants in the Maryland statutory case have indicated their intent to appeal. As a result, the implications of these court decisions for control share provisions are not yet final and may further play out in 2024.

III. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE DEVELOPMENTS

The legislative and regulatory landscape with respect to ESG investing was subject to significant developments and massive change. The initiatives spanned the scope of the ESG debate and involved actions by federal regulators, state legislative bodies, state executive agencies, and civil litigation.

A. Federal ESG Regulation and Enforcement

From a regulatory perspective, the SEC was relatively quiet in the ESG space. While the SEC proposed two significant ESG-related proposals in 2022 (**climate risk disclosure for public issuers** and **ESG disclosures for funds and advisers**), the SEC did not finalize either proposal in 2023. The SEC did finalize a proposal relating to mutual fund names (see above) that included some substantive conditions with respect to funds whose names suggest ESG investing but the broader proposals remain under consideration.

ESG was an SEC examination priority in 2023 and featured in SEC examinations of investment advisers. In 2023, the SEC concluded its investigation into the ESG marketing practices of DWS Investment Management Americas, Inc., with a **settlement released in September.** This settlement built on the themes from settlements released in 2022 and underscored the SEC's view that statements concerning how ESG factors are incorporated into an investment strategy are material statements for investors that should be substantiated with firm action, and that where ESG processes are included in firm marketing, the firm should adopt and implement policies and procedures reasonably designed to ensure the statements concerning such processes are accurate.

B. State Legislative Activity

While the SEC was relatively quiet in 2023 as compared to 2022, the various US states were extremely active. On the state legislative front, state legislatures considered—and several states passed—ESG-related bills. Certain state legislative efforts were intended to curtail the use of ESG in investing, so called "anti-ESG" bills. These bills tended to share certain features: (i) none of the bills entirely ban the use of ESG factors in making investments; (ii) they only apply to the disposition or management of state funds; and (iii) to the extent the bills regulate the conduct of asset managers, they generally do so indirectly. The bills tended to take one of three different approaches: (i) defining fiduciary regulations as requiring the consideration of only "pecuniary factors;" (ii) identifying companies who "boycott" certain protected industries without a "business purpose" and restricting investment in and contracting with such companies; and (iii) broadly prohibiting the use of ESG factors to "discriminate" against individuals or companies. All told, 14 states adopted some form of "anti-ESG" legislation in 2023.

Some states also considered "pro-ESG" legislation (i.e., legislation that would advance certain ESG goals). In general, the "pro-ESG" legislation tended to place restrictions on the ability for state governmental entities (typically pension plans) to invest in certain industries or sectors (e.g., fossil fuels) or encourage the consideration of sustainable investing practices. These bills were not as prolific as the "anti-ESG" bills, as they were under consideration in 10 states, and only Colorado adopted a bill along these lines.

California, however, was a notable exception. In 2023, California adopted two significant

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ESG-related bill packages. The first would require large companies doing business in California to publicly report their carbon emissions information, as well as their assessment of climate-related risks. This bill package went further than the SEC's proposed climate risk disclosure in that it will require the disclosure of Scope 3 emissions (i.e., emissions generated by the company's suppliers and consumers of the company's products), and it will apply to public and private companies over the applicable size thresholds.

California also passed the first major legislation regulating how companies can disclose the impact of carbon offsets in marketing materials. Specifically, under the new California law, companies who rely on the purchase of carbon offsets to support claims of net zero or reduced emissions are required to disclose key information that substantiates how the offsets work.

C. State Regulatory Activity

In addition to the legislative actions described above, the first state regulatory actions concerning ESG occurred in 2023. The securities regulators in two states, Missouri and Wyoming, proposed, and in the case of Missouri, adopted substantially similar "anti-ESG" regulations. Specifically, the regulations require investment advisers and broker-dealers to provide certain disclosures and obtain client and customer consent where the investment adviser or broker-dealer "incorporates a social objective" into an investment recommendation.

These regulations appear to be the first attempts by states to conduct direct regulation of asset manager substantive conduct, and they pose important legal questions concerning the preemption of asset manager regulation at the state level for federally registered asset managers. In fact, the Securities Industry and Financial Markets Association (SIFMA) has filed suit challenging the Missouri regulations on the grounds that, among other things, it violates federal preemption rules. This case will be a critical test of the federal preemption and could have implications for broker-dealers and investment advisers that extend well beyond ESG matters.

D. State Investigative Activity and Litigation

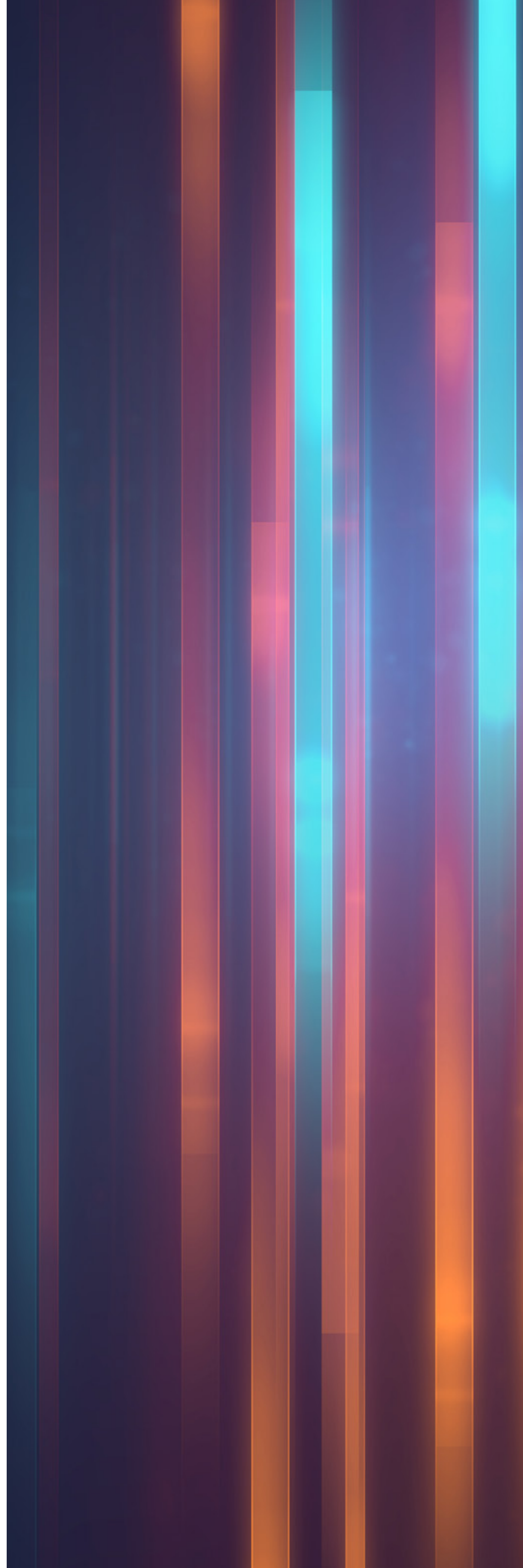
Other state executive agencies also raised concerns, requested information, and launched investigations. Specifically in March 2023, 21 state attorneys general sent a form letter to asset managers raising concerns about the consideration of ESG factors in proxy voting and noting concerns about asset manager participation in third-party organizations, such as the Net Zero Asset Managers Initiative (NZAMI) and Climate Action 100+ (CA100+).

While this initial March letter did not request any action on the part of asset managers or the production of information, a letter sent by 18 state treasurers in May did. Specifically, these treasurers sent a list of specific information requests to 20 large asset managers concerning how the asset managers addressed certain ESG factors in voting proxies.

The May letter from the state treasurers was not issued under subpoena power, but later in the same month, four attorneys general launched an official investigation into asset manager proxy voting and membership in NZAMI and CA100+. These attorneys general (representing Montana, Tennessee, Alabama, and Kentucky—and later joined by Indiana) sent civil investigative demands or subpoenas to dozens of asset managers regarding their involvement in CA100+ and NZAMI. The requests also sought information about how the asset managers cast proxy votes in connection with shareholder proposals relating to greenhouse gas emissions at certain banks, insurance companies, or energy and utility companies.

In addition to these multistate initiatives, in 2023, state agencies in states with “anti-boycott” laws sent “verification requests” to financial institutions to enable them to compile their list of financial institutions who “boycott” the industries protected under the applicable state statute. Specifically, 2023 saw the first such request from the state of Oklahoma and, in what seems as if it will become an annual occurrence, the second verification request from the Comptroller of the state of Texas. Both of these verification requests included information requests relating not only to ESG policies of the recipients, but also included requests relating to how the asset managers voted proxies and engaged with issuers in which they invested.

The ESG state executive actions for 2023 closed with the first ever “anti-ESG” lawsuit filed against an asset manager. In December, the attorney general of Tennessee filed a complaint against Blackrock alleging violations of the Tennessee consumer protection statutes based on misleading statements made by Blackrock concerning its ESG practices. In sum, the Tennessee attorney general alleges that Blackrock inappropriately implemented ESG considerations in investment products that were not marketed or advertised as ESG related (i.e., “greenhushing”).



IV. LOOKING AHEAD TO 2024

A. Regulatory

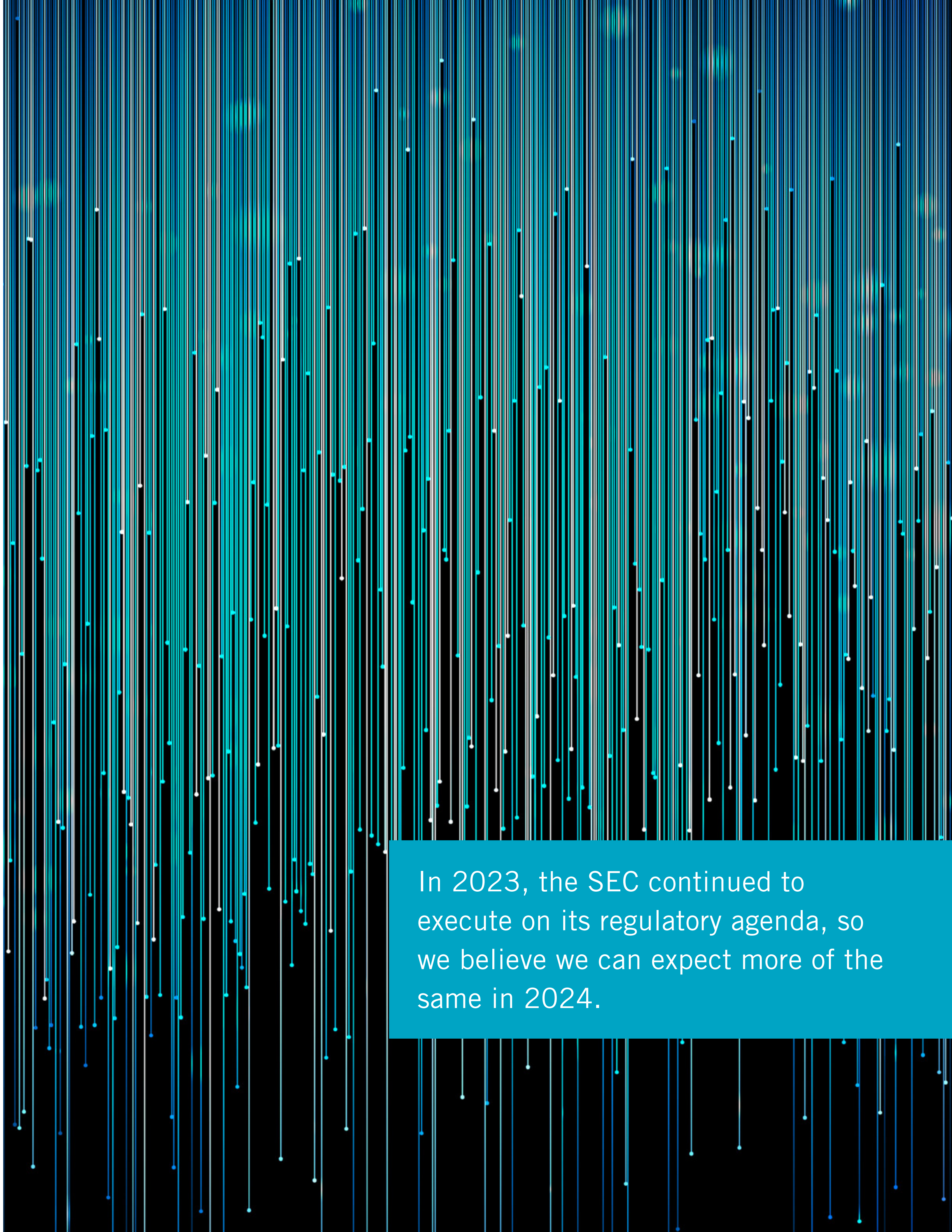
While the future eludes accurate prediction, we can make some informed conjectures about what 2024 will bring. In 2023, the SEC continued to execute on its regulatory agenda, so we believe we can expect more of the same in 2024, perhaps with even more urgency. Asset managers should expect several of the rules currently in the proposed stage to be finalized—although not necessarily without subsequent legal challenge from the industry. In particular, the SEC is expected to issue final rules on topics including, among others, public company climate risk disclosure, fund and adviser ESG disclosure, cybersecurity risk management, investment adviser outsourcing, and potentially liquidity risk management.

B. SEC 2024 Examination and Enforcement Priorities

On 16 October 2023, the SEC released its examination priorities for fiscal year 2024. The SEC plans to ensure that advisers adhere to their duties of care and loyalty. They will focus on investment advice involving complex products, high-cost and illiquid products, and products with unconventional investment strategies. When reviewing an adviser's compliance program, they will consider the marketing practices and disclosure of marketing information on Form ADV; compensation arrangements; valuation assessments of illiquid or difficult to value assets; controls to protect clients' material, nonpublic information; and disclosure assessments to review filings. Advisers to private funds should be prepared for the SEC to focus on portfolio management risks, adherence to contract requirements for limited partnerships, calculation and allocation of fees and expenses, due diligence policies, conflicts and disclosures for funds managed alongside registered investment companies, compliance with the Adviser Act's requirements regarding custody, and procedures for reporting on Form ADV. Exams of investment companies are expected to focus on policies and procedures concerning calculation of advisory fees and fee waivers, as well as valuation practices, risk management, and compliance with exemptive order conditions. With respect to broker-dealers, the SEC will focus on compliance with the standard of conduct set forth under Regulation Best Interest. The SEC highlighted three key risk areas: information security and operational resiliency; crypto and fintech; and anti-money laundering (AML).

First, regarding information security and operational resiliency, the SEC will focus on reviewing companies' cybersecurity policies and controls. This will involve thorough examinations of companies' internal controls, governance practices, oversight of third-party vendors, and responses to cyber-related incidents. The review will consider employee training programs on identity theft prevention and the adequacy of written policies safeguarding customer information across various offices. Additionally, the SEC will assess how firms identify and evaluate risks to essential operations related to third-party vendor engagement. Notably, compliance with recently adopted SEC rule changes, effective from 28 May 2024, to shorten settlement cycles for broker-dealer transactions, will be a key focus of examinations.

Second, the SEC will continue to monitor the evolving landscape of fintech, specifically focusing on the growing role of artificial intelligence and automated tools in investment services, and its associated risks. Further, the SEC will continue reviewing companies' involvement with crypto-assets



In 2023, the SEC continued to execute on its regulatory agenda, so we believe we can expect more of the same in 2024.

and related products, emphasizing compliance and marketing materials. Companies engaged in crypto-assets are urged to regularly enhance their compliance practices, risk disclosures, and operational resiliency practices. The SEC will also assess whether firms effectively communicate product details to customers, with particular attention to senior investors and investments involving retirement assets. Compliance with custody requirements, as per Rule 206(4)-2 of the Advisers Act, is mandatory for crypto-assets classified as funds or securities. The SEC has adopted a comprehensive enforcement approach in this domain, extending actions to crypto-platforms, exchanges, and individuals for alleged failures to register and sell unregistered crypto-assets. Litigation has contested the SEC's jurisdiction over cryptocurrency, but the SEC's reiteration of crypto as a key risk area underscores its commitment to continued vigilance in this space.

Finally, newly added to this year's priorities is the scrutiny of AML procedures and adherence to the Bank Secrecy Act of 1970. The SEC will assess firms' AML programs, examining their alignment with unique AML risks tied to business models. Key areas of focus include conducting independent testing, establishing customer identification programs, and fulfilling obligations for filing Suspicious Activity Reports. Additionally, the SEC will assess compliance with Office of Foreign Assets Control sanctions by broker-dealers and advisers. The SEC has recently reinforced its commitment to oversight through enforcement actions, notably pursuing charges related to AML violations. A notable case involved a registered representative who faced charges for neglecting to raise red flags on suspicious transactions, leading to his firm's failure to file mandated Suspicious Activity Reports.

C. ESG

2024 is likely to be as busy, if not busier, than 2023 with respect to ESG matters. As noted above, the SEC should be expected to finalize regulation on public company climate risk disclosure and fund and adviser ESG disclosure. Although ESG was not included on the SEC Division of Examinations list of priorities, asset managers who promote their ESG products, processes, or capabilities should continue to expect SEC examination scrutiny on their ESG claims.

In addition, we expect that state legislatures will continue to consider ESG-related legislation, both "pro-ESG" and "anti-ESG." In fact, even before the end of 2023, new "anti-ESG" legislation has been pre-filed in four states for consideration in their 2024 sessions. We may see movement on the multistate ESG investigation, with more ESG-related suits filed in 2024. That said, given the SIFMA lawsuit against the state of Missouri, state regulatory agencies may hold off on new substantive ESG regulation while that case develops.

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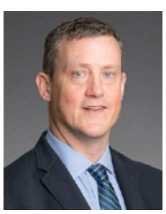
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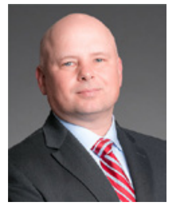
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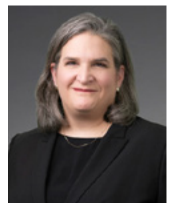
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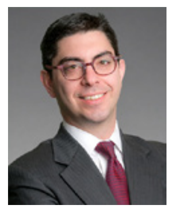
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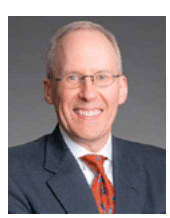
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